

**Improved Screening of Potentially Fraudulent  
Employment Tax Refunds Would Reduce  
Significant Processing Delays  
for Legitimate Refunds**

**September 2003**

**Reference Number: 2003-30-173**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

September 3, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Assistant Inspector General for Audit (Small Business and  
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SUBJECT: Final Audit Report - Improved Screening of Potentially  
Fraudulent Employment Tax Refunds Would Reduce Significant  
Processing Delays for Legitimate Refunds (Audit # 200230027)

This report presents the results of our review of the Internal Revenue Service (IRS) program to identify potentially fraudulent employment tax refunds. The objective was to determine whether the IRS has controls in place to identify and stop frivolous claims for refunds of previously paid employment taxes.

All employers who pay wages subject to income tax withholding or Social Security and Medicare taxes must file an Employer's Quarterly Federal Tax Return (Form 941) each quarter and make appropriate employment tax payments. Anti-tax groups have unsuccessfully argued that wages are not taxable because they do not meet the definition of gross income as defined by the law. Proponents of this position cite Treasury Regulation 861<sup>1</sup> and interpret the regulation to exclude any sources of income from American-owned companies. This argument has become known at the IRS as the "I.R.C. 861 Position."

Despite using this argument unsuccessfully, promoters in recent years have encouraged employers to stop withholding or paying employment taxes on their employees' wages. Most recently, promoters have advocated filing claims to request refunds of previously paid taxes. If an employment tax return was previously filed, refunds are requested by filing a Supporting Statement To Correct Information (Form 941c) or an amended Form 941. If payments have been made but an

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<sup>1</sup> Treas. Reg. § 1.861-8 (as amended in 2001).

employment tax return has not been filed, the taxpayer simply files an original Form 941 showing no wages paid and requesting that all payments be refunded. The IRS refers to these claims as Employer Abatement Schemes. Some of these claims have been inappropriately processed and the taxes abated or refunded.

According to the IRS Commissioner, identifying and combating abusive tax schemes are the highest compliance priorities within the IRS. The Congress has also expressed serious concerns about such tax schemes.

In summary, we found that the IRS recognized the significance of identifying frivolous claims made by employers for refunds of previously paid employment taxes and has taken appropriate action against the filers and promoters of such claims. However, significant delays in working these cases in the IRS' Frivolous Return Program are having a negative effect on taxpayers making legitimate claims and could result in frivolous claims being refunded. Many of the cases identified as potentially frivolous employment tax claims appear to be legitimate claims, and some of these cases actually originated with taxpayers appropriately responding to an IRS notice. We also determined that frivolous claims for employment tax refunds might be more effectively identified using computers.

We recommended that the Acting Director, Compliance, Small Business/Self-Employed (SB/SE) Division, develop procedures to control and monitor the age of potentially frivolous employment tax cases in the Frivolous Return Program. The Acting Director should ensure that more specific screening criteria and research procedures are provided to employees working this program. The Acting Director should also consider using computer programming to identify potential Employer Abatement Scheme cases. Finally, we recommended that the Acting Director, Compliance, SB/SE Division, work with the Director, Customer Account Services, Wage and Investment Division, to revise an IRS notice and/or Frivolous Return Program screening procedures to ensure that taxpayers responding to one IRS notice do not receive another notice addressing the same issue but implying that they may be part of an Employer Abatement Scheme.

Management's Response: IRS management agreed with the findings and recommendations presented in this report. They are taking a number of actions to improve the controls over frivolous claims for refunds of employment tax, some of which have already been completed. IRS management has increased staffing and is monitoring the case inventory for age to ensure case movement and work continuity. In addition, the screening criteria have been modified and supplemental criteria are under development. Research procedures have been revised and future improvements are planned. IRS management has also begun the process of developing a computer program to more easily identify frivolous claims and is pursuing an external contract that will improve the identification of frivolous claims by using advanced computer techniques. Finally, IRS management plans to evaluate the aforementioned IRS notice to avoid additional taxpayer burden.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker Pearson, Director (Small Business Compliance), at (410) 962-9637.

**Improved Screening of Potentially Fraudulent Employment Tax Refunds  
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## Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds

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### Background

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All employers who pay wages subject to income tax withholding or Social Security and Medicare taxes must file an Employer's Quarterly Federal Tax Return (Form 941) each quarter of the tax year and make appropriate employment tax payments during that quarter.

Anti-tax groups have unsuccessfully argued that wages are not taxable because they do not meet the definition of gross income as defined by the law. Proponents of this position cite Treasury Regulation 861<sup>1</sup> and interpret the Regulation to exclude any sources of income from American-owned companies. This argument has become known at the Internal Revenue Service (IRS) as the "Internal Revenue Code (I.R.C.) 861 Position."

This position is refuted by the terms of I.R.C. § 61,<sup>2</sup> which include in gross income "all income from whatever source derived." The courts have also categorically rejected all arguments similar to the I.R.C. 861 Position and upheld criminal convictions of individuals who based their refusal to pay on such contentions.

Despite using this argument unsuccessfully, promoters in recent years have encouraged employers to stop withholding or paying employment taxes on their employees' wages. Most recently, promoters have advocated filing claims to request refunds of previously paid taxes. If an employment tax return was previously filed, refunds are requested by filing a Supporting Statement To Correct Information (Form 941c) or an amended Form 941. If payments have been made but an employment tax return has not been filed, the taxpayer simply files an original Form 941 showing no wages paid and requesting that all payments be refunded. The IRS refers to these claims as Employer Abatement Schemes. Some of these claims have been inappropriately processed and the taxes abated or refunded.

According to the IRS Commissioner, identifying and combating abusive tax schemes are the highest compliance priorities within the IRS. The Congress has also expressed serious concerns about such tax schemes. Senator Charles

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<sup>1</sup> Treas. Reg. § 1.861-8 (as amended in 2001).

<sup>2</sup> 26 U.S.C. § 61 (1994 & Supp. IV 1998).

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Grassley, during a recent hearing before the Senate Committee on Finance, referred specifically to promoters who are encouraging employers not to withhold income and payroll taxes for their employees. He stated, “These employees are put in a terrible position, having to choose between the tax man and their jobs. That is not right and it should be a top enforcement priority of our Internal Revenue Service.”

Potentially frivolous employment tax claims are generally identified manually by IRS employees who process those claims at one of the IRS campuses.<sup>3</sup> These employees route the claims to the Frivolous Return Program at the IRS’ Ogden Campus for screening. Screeners in the Frivolous Return Program screen the claims, contact the taxpayers if necessary, and refer claims they determine to be frivolous to the field Compliance function for further action.

Timely and accurately identifying frivolous employment tax claims is important for several reasons. Not identifying these claims, or not identifying them timely, could negatively affect voluntary compliance and could result in loss of revenue for the Federal Government. However, identifying legitimate claims as potentially frivolous and significantly delaying associated refunds could have significant negative impact on compliant taxpayers.<sup>4</sup>

We conducted our audit at the Frivolous Return Program Offices located at the Ogden IRS Campus from March 2002 to February 2003. The audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented

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<sup>3</sup> The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

<sup>4</sup> There are a number of reasons why employers legitimately file for refunds of previously paid employment taxes. Some common examples are: (1) household employers may mistakenly file a Form 941 with tax payments rather than appropriately filing a Household Employment Taxes (Schedule H) with their individual income tax return, (2) payments made to partners or a sole proprietor are sometimes inappropriately treated as wages by the business, and (3) a variety of accounting errors can result in legitimate filings for previously paid employment tax.

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### **The Internal Revenue Service Has Been Proactive in Addressing Promoters and Employers Who Advocate the Nonfiling and Nonpaying of Employment Taxes**

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in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS recognized the significance of identifying frivolous claims made by employers for refunds of previously paid employment taxes and has taken appropriate action against the filers and promoters of such claims. Following are some of the actions taken by the IRS to address these frivolous claims:

- The IRS has educated employers, employees, and promoters regarding the legality of these claims and the potential consequences of making and promoting such claims. The IRS has prepared numerous news releases and has publicized this issue on its web site.
- As discussed earlier, a group has been created in the IRS' Frivolous Return Program to screen potentially frivolous claims for refunds of employment taxes and to route appropriate cases to field Compliance functions, where the cases are further reviewed.<sup>5</sup>
- Criteria and procedures were developed for use by IRS Submission Processing and Accounts Management employees to manually identify frivolous employment tax claims and route the claims to the Frivolous Return Program.
- Civil and criminal actions have been initiated against some promoters of tax schemes involving frivolous employment tax claims.

The actions taken by the IRS should have a positive impact on compliance; however, changes are needed to improve the screening process and lessen its impact on taxpayers filing legitimate employment tax claims.

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<sup>5</sup> Another audit was conducted of the work performed by the IRS after the cases were referred to the field Compliance functions. The objective of that audit was to determine if the IRS' Compliance function was effectively working I.R.C. 861 Position cases and if proper actions were taken to prevent noncompliance. For more information see *Controls Over the Employer Abatement Program Cases Can Be Improved* (Reference Number 2003-30-147, dated July 2003).



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### **Delays in Working Potentially Frivolous Employment Tax Claims Negatively Affect Legitimate Taxpayers and Could Result in Frivolous Claims Being Refunded**

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The process of screening potentially frivolous employment tax claims involves several steps. After receiving cases from employees in processing units at any of the IRS campuses, screeners in the Frivolous Return Program review the claims and perform research to determine if the taxpayers are participating in an Employer Abatement Scheme. If screeners are unable to make this determination, or if they determine the taxpayers are involved in a scheme, they send the claims back to the processing units to be entered into IRS computers and to have any associated payments frozen from refunding.

After being processed to IRS computers, the claims are returned to the Frivolous Return Program. Employees in the Frivolous Return Program send letters to the taxpayers asking them to explain why they are not liable for employment taxes for the period in question and detailing the IRS' stand on Employer Abatement Schemes.

Taxpayers are given 30 days to respond. If a taxpayer does not respond, or if the taxpayer's response does not satisfy screeners that the taxpayer is not involved in a scheme, the claim is routed to a Compliance field function for further action.

We reviewed a sample of 231 claims that were at various stages in the screening process and found significant delays at each stage. From documentation available on the cases in our sample, we determined that claims which had been through the entire screening process, including the sending of letters to taxpayers and the receipt of responses from those taxpayers, had been in the Frivolous Return Program an average of 458 days.

The following table provides further details of our sample, the average ages of cases in the sample, and the average refunds requested by taxpayers:

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<b>Average Ages of Potential Employer Abatement Scheme Cases in the Frivolous Return Program (FRP)</b>				
<b>Stage in the Screening Process</b>	<b>No. of Cases in Inventory</b>	<b>No. of Cases Sampled</b>	<b>Average Days in FRP</b>	<b>Average Refund Requested</b>
Awaiting Initial Screening	554	55	96	\$5,600
Screened, Awaiting Letter to Taxpayer	1,016	102	164	\$8,867
Letter Sent, Awaiting Correspondence From Taxpayer	637	64	217	\$4,886
Correspondence Received From Taxpayer	48	10	458	\$2,900
<b>Total Cases in Inventory: 2,255</b>				
<b>Total Cases Sampled: 231</b>				

*Source: Treasury Inspector General for Tax Administration (TIGTA) sample of Employer Abatement Scheme cases in the FRP inventory.*

The screening of potentially frivolous employment tax claims is the primary control against Employer Abatement Schemes. Control activities should be effective and efficient in accomplishing an agency's control objectives. Such significant delays in processing potentially frivolous employment tax claims lessen the effectiveness and efficiency of this control.

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Several factors contributed to this condition:

- Only one tax examiner in the Frivolous Return Program worked these cases, and he spent only part of his time on this Program.<sup>6</sup>
- Management had not established timeliness standards for working these cases and did not have a system to determine or monitor the ages of cases in inventory.
- Many of these cases were not filed or were misfiled. For example, in stacks of unfiled new receipts, we found 71 cases that had been screened and should have been sent for processing to IRS computers. In those same stacks, we found 79 cases that had been processed and needed letters sent to taxpayers.
- Before letters were sent to taxpayers, cases were filed in Taxpayer Identification Number order with no consideration given to the dates the cases were received or the amounts of the refunds requested.

As a result, we found taxpayers filing what appeared to be legitimate employment tax claims who were significantly burdened by delays, and others who filed claims that may have been frivolous who could have benefited from the delays. Please see Appendix IV for examples.

Potentially frivolous claims are not subject to control on the IRS' Integrated Data Retrieval System (IDRS)<sup>7</sup> until letters are issued to taxpayers; therefore, other IRS employees receiving correspondence or phone calls regarding one of these claims may not know that it is being reviewed by the Frivolous Return Program. This increases the likelihood that a refund may be inappropriately released, particularly if screening of the claim is significantly delayed.

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<sup>6</sup> Management in the Frivolous Return Program had trained two other employees to work these cases but both had taken other jobs.

<sup>7</sup> IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records. This system is also used by IRS employees to establish "control" over a taxpayer account so multiple employees do not access and make adjustments to the same account at the same time.

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### Recommendations

The Acting Director, Compliance, Small Business/Self-Employed (SB/SE) Division, should ensure that the following actions are taken:

1. Develop procedures to control cases as they are received in the Frivolous Return Program and to monitor the age of cases in inventory. Consideration should be given to using the IDRS.

Management's Response: IRS management currently requires all cases identified as frivolous to be controlled on IDRS. In addition, they will monitor their inventory for age as a standard operating procedure to ensure case movement and work continuity.

2. Establish timeliness standards for working cases through each step of the screening process.

Management's Response: IRS management now requires potentially frivolous returns to be screened and forwarded for processing within 2 business days if they are determined to be valid claims. The Internal Revenue Manual will be revised to reflect this new requirement.

3. Analyze potential Employer Abatement Scheme workloads and determine an appropriate staffing level to allow cases to be worked timely.

Management's Response: IRS management increased staffing to address the growth of frivolous claims for refunds and will balance resources to address unanticipated spikes in receipts.

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### Many Cases Identified As Frivolous Employment Tax Claims Appear to Be Legitimate Claims

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Twenty-eight (12 percent) of our sample of 231 claims that were in the Frivolous Return Program's inventory of frivolous employment tax claims were clearly not frivolous claims. These 28 claims were at various stages of processing in the Frivolous Return Program. More than half of them had already been screened by an employee in the Program, and either a letter had been sent to the taxpayer questioning the claim or a letter was waiting to be sent. Most of the 28 claims fell in 1 of the following categories:

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- Taxpayer returns requesting the overpaid taxes be applied to other tax modules rather than be refunded. In fact, some of these returns requested abatements that resulted in overpayments of nominal sums of money, which the taxpayers asked be applied to other modules.
- Responses to an IRS notice informing taxpayers that payments had posted to their accounts, but no corresponding returns had posted. This notice invites taxpayers to file returns requesting refunds of employment tax payments. (This issue is discussed further later in this report.)
- Claims for which taxpayers had attached logical explanations for the refunds that were not related to the I.R.C. 861 Position argument in any way.
- Protective claims related to a pending tax court case regarding employment taxes paid on severance payments made to laid-off employees.

Accurately identifying potentially frivolous returns is key to taking successful compliance action against scheme participants and promoters and minimizing unnecessary burden on taxpayers filing legitimate claims.

The IRS profiled the returns and other correspondence related to those claims it had identified as being frivolous. The results of this profiling were provided in an “alert” to employees processing the original and amended employment tax returns. However, the profile information was so general it could apply to almost any employment tax return claiming no tax owed. Because the profile did not clearly specify refund returns, tax returns requesting payment transfers to other accounts were identified as potentially frivolous. Also, the alert did not provide any dollar tolerance for cases to be sent for screening.

At the time of our review, research procedures provided to employees in the Frivolous Return Program were not adequate to determine the legitimacy of a claim. Subsequent to our review, draft desk procedures were developed. However, those procedures were still very general. More specific research steps could better distinguish between an employment tax claim that was

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potentially frivolous and a completely legitimate claim. For example, employees could:

- Review accounts on IRS computers for filing patterns before and after the period of the return in question. Has the employer been compliant before and after? Has the employer received refunds from other tax periods?
- Review information returns filed for employers to determine if they are receiving income from outside sources (indicating the employers are still in business).
- Review employers' individual income tax accounts to determine if wages were included as expenses on Profit or Loss From Business (Schedule C) or to determine if an employer or partner paid self-employment taxes on payments mistakenly reported as wages.

Nonspecific procedures and instructions resulted in inconsistent research being performed on these cases. For example, one tax examiner who worked the Program performed significant research on the IDRS to determine the prior and subsequent filing history of the taxpayer filing an employment tax claim, while another did only limited research before having a taxpayer's refund frozen and sending correspondence to the taxpayer.

Further, the Frivolous Return Program did not compile program statistics that could be used as feedback to those employee groups referring potentially frivolous cases, and it did not use the feedback provided from the Compliance function regarding those cases that it referred for further review.

As a result, many taxpayers filing legitimate claims had refunds delayed, received unnecessary letters from the IRS questioning the legitimacy of their claim, and may have received unnecessary payment due notices because amounts were not timely transferred to other tax periods as they requested. Because the letter sent to taxpayers specifically states that their returns "requested a refund of deposits they made for employment taxes," taxpayers requesting that money be transferred to another account would be confused and frustrated by the IRS' actions.

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### Recommendations

The Acting Director, Compliance, SB/SE Division, should ensure that the following actions are taken:

4. Provide criteria for referring cases to the Frivolous Return Program which are much more specific.  
Consider including a dollar tolerance in these criteria.

Management's Response: IRS management modified screening criteria based on dollar amounts in May 2003, and is currently developing supplementary criteria.

5. Develop specific research procedures and criteria to identify truly "frivolous" employment tax claims and to ensure that legitimate claims receive prompt processing, and then update those procedures as experience in this area warrants.

Management's Response: IRS management has revised procedural guidelines to improve the accuracy of identifying frivolous claims. They are also in the process of developing a computer program that will identify them systemically. Both methods will be updated as new schemes are identified.

6. Develop performance measures to evaluate the success of this Program. Methods should be developed for using feedback from field Compliance functions on cases referred for action. Similar feedback should be provided to processing groups referring potentially frivolous claims to the Frivolous Return Program.

Management's Response: IRS management plans to develop performance measures and use feedback on cases referred to the program for action. They currently provide feedback to referring offices.

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### Proper Responses to an Internal Revenue Service Notice Sometimes Appear to Be Frivolous Claims for Refunds

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Six of the 28 cases that were clearly not frivolous employment tax claims had an IRS notice (Computer Paragraph 080) attached to the return. At least one other had "not liable" written across the front of the return. Computer Paragraph 080 is a notice issued by the IRS to taxpayers who have made tax payments but have not filed tax returns related to those payments. The notice reminds

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taxpayers that they have money posted to their tax accounts but have not filed a tax return. The notice gives taxpayers several options, one of which states that if taxpayers are not liable for filing a return for the tax period in question and they would like their payments refunded to them, they should write “not liable” across the front of a return, sign and date it, and send it to the IRS. The notice states that the payments will be refunded to the taxpayers if they owe no other taxes or obligations.

Because the notice does not ask taxpayers to include an explanation of why they are not liable for employment taxes, a return filed by the taxpayer requesting the refund of previously paid amounts meets the profile the Frivolous Return Program established for potentially frivolous employment tax claims. Taxpayers responding to one IRS notice exactly as they were instructed to do get a letter asking for a further explanation before their refund request can be granted. The IRS letter also explains the pitfalls of participating in an Employer Abatement Scheme.

The IRS is in the process of changing Computer Paragraph 080. The proposed changes will completely eliminate the option discussing what taxpayers should do if they are not liable for filing a return and will add the wording, “You must file a return to claim any refund due you.” However, any employment tax return filed by the taxpayer showing zero tax and claiming a refund of previously paid amounts will most likely result in the return being identified as potentially frivolous. Therefore, the taxpayer will still receive a second notice from the IRS asking for additional information and implying that the taxpayer may be participating in a scheme. This increases burden on these taxpayers and will result in taxpayer dissatisfaction with the IRS.

### **Recommendation**

7. The Acting Director, Compliance, SB/SE Division, and the Director, Customer Account Services, Wage and Investment Division, should work together to develop revisions to Computer Paragraph 080 and/or to Frivolous Return Program screening procedures to



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ensure that taxpayers responding to one IRS notice do not receive another regarding the same issue which also implies that the taxpayer may be participating in a scheme.

Management's Response: IRS management will evaluate the notice for necessary content changes.

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### Frivolous Employment Tax Claims Could Be Identified by Computer

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Potentially frivolous claims for employment tax refunds might be more effectively identified using computers. After reviewing processing instructions for original Forms 941, we determined that all the information necessary to identify one of these Forms as warranting screening in the Frivolous Return Program was entered into IRS computers. Therefore, computer programs could be written to identify potentially frivolous claims filed on these Forms before they post to the IRS' Business Master File.<sup>8</sup> The computer programs would be essentially the same as programs we wrote during a previous audit to identify frivolous claims for reparations credits.<sup>9</sup>

For this audit, we wrote a computer program to identify potentially frivolous Forms 941c and amended Forms 941. We identified 6,460 claims processed to the IRS Business Master File for all tax periods in 1997 through 2001 for which employers were claiming refunds of all employment tax payments made totaling \$1,000 or more. Refunds totaling over \$61 million had been issued for these 6,460 claims. We selected a judgmental sample of 100 of these returns and determined that all 100 met Frivolous Return Programs criteria for referral for initial screening, and 17 warranted letters to taxpayers. The Frivolous Return Program concurred with our determination on these 17 returns. We could not determine if any of the cases identified by our computer run had been screened and released by the Frivolous Return Program. Most of the

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<sup>8</sup> The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

<sup>9</sup> For additional information, see TIGTA report *Computer Programming Can Be Used to More Effectively Stop Refunds on Illegal Claims for Reparations Credits* (Reference Number 2002-30-071, dated March 2002).

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cases identified by our computer program were refunded prior to the establishment of the database in the Frivolous Return Program to control potentially frivolous employment tax claims.

The accurate identification of potentially frivolous returns is key to taking successful compliance action against scheme perpetrators and is also key to minimizing unnecessary burden on taxpayers filing legitimate claims. As mentioned earlier, the IRS relies on employees who process original and amended employment tax returns to manually identify frivolous claims. As a result, legitimate claims may be delayed and frivolous claims may be missed.

### **Recommendation**

8. The Acting Director, Compliance, SB/SE Division, should consider using computer programming to identify both original and amended employment tax returns that may be part of Employer Abatement Schemes.

Management's Response: IRS management has begun the process of developing a computer program to more easily identify frivolous claims. This program is scheduled for implementation in January 2004. They are also pursuing an external contract that will improve the identification of frivolous claims by using advanced computer techniques.

**Detailed Objective, Scope, and Methodology**

The objective of the review was to determine whether the Internal Revenue Service (IRS) has controls in place to identify and stop frivolous claims for refunds of previously paid employment taxes. To accomplish our objective, we:

- I. Identified the controls the IRS has implemented to ensure frivolous refund claims for employment taxes are identified and stopped from refunding.
  - A. Determined the filing criteria the IRS has set for businesses wanting to obtain refunds of prior employment tax deposits.
  - B. Reviewed the Internal Revenue Manual and training manuals that outline the proper processing procedures for these claims and determined the controls in place to identify frivolous claims.
  - C. Interviewed management personnel responsible for processing refund claims and determined methods in place for identifying and disallowing the frivolous claims. This included determining statistics maintained to evaluate the Frivolous Return Program and enforcement actions available to the IRS.
  - D. Reviewed a judgmental sample<sup>1</sup> of 231 employment tax claims from a total of 2,255 that were in the Frivolous Return Program's inventory at various stages in the screening process as of January 2003 (the sample was chosen by selecting the first case at random then choosing every n<sup>th</sup> one). The claims were reviewed to determine the types of cases within the inventory and the age of the inventory.
- II. Tested and evaluated the controls the IRS has in place to identify frivolous claims for refunds of previously deposited employment taxes and determined whether current controls are effective or whether additional controls are needed.
  - A. Using a computer program, identified business taxpayers that filed amended returns requesting refunds of prior employment tax deposits. The computer program identified 6,460 returns claiming refunds of at least \$1,000 from 1997 through 2001. We tested the computer data to ensure it met our criteria.

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<sup>1</sup> A judgmental sample was selected because no projections were planned or made.

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- B. Reviewed and analyzed a judgmental sample<sup>2</sup> of 100 returns identified by the computer program as claiming refunds of prior employment tax deposits (to pull the sample, we used a computer program which randomly selected each case). The returns were reviewed and analyzed to determine whether they met frivolous return criteria and whether they were processed appropriately.
- C. Determined whether computer programs could be written to identify potentially frivolous claims before they post to the IRS' Business Master File.<sup>3</sup>

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<sup>2</sup> A judgmental sample was selected because of the significant time and resource commitments involved in reviewing a statistically valid sample. Because of the nature of the data, no projections were made.

<sup>3</sup> The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

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**Appendix II**

**Major Contributors to This Report**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner for Services and Enforcement N:SE  
Acting Deputy Commissioner, Small Business/Self-Employed Division S  
Deputy Commissioner, Wage and Investment Division W  
Staff Assistant, Small Business/Self-Employed Division S  
Acting Director, Compliance, Small Business/Self-Employed Division S:C  
Director, Customer Account Services, Wage and Investment Division W:CAS  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:AR:M  
Audit Liaisons:  
    Commissioner, Small Business/Self-Employed Division S  
    Commissioner, Wage and Investment Division W

### **Case Examples**

During the audit, we found taxpayers filing what appeared to be legitimate employment tax claims who were significantly burdened by delays, and others who filed claims that may have been frivolous who could have benefited from the delays. Examples are provided below.

#### **Case Example #1**

A taxpayer filed an original Employer's Quarterly Federal Tax Return (Form 941) in May 2001 claiming no wages and asking for the employment tax payments made (which totaled less than \$300) to be applied to a subsequent tax return. The return was mistakenly identified as a potential Employer Abatement Scheme case and received in the Frivolous Return Program that same month. The Internal Revenue Service (IRS) sent the taxpayer a letter 1 year after receipt in the Frivolous Return Program asking for an explanation of why the return (1) reflected no wages and (2) requested a refund of the deposits made for employment taxes (however, the return did not actually request a refund). The letter also implied that the taxpayer might be participating in an Employer Abatement Scheme. One month later, the taxpayer responded with a valid explanation for the claim. At the end of September 2002, the taxpayer finally received a refund, but the Frivolous Return Program did not seem to be aware of it since it was part of the Program's open inventory as of January 2003.

#### **Case Example #2**

A taxpayer filed a Form 941 in January 2002. Attached to the Form was a note explaining that the same Form had been originally sent in October 2001 but apparently had not been received by the IRS. The Form 941 met the general criteria for an Employer Abatement Scheme and was routed to the Frivolous Return Program. The return was screened and identified as a potentially frivolous claim, and the taxpayer's refund was frozen. However, no subsequent action was taken on the case. As of January 2003 (1 year after the taxpayer filed the second claim), no letter had been sent to the taxpayer. In the meantime, the taxpayer received a refund in May 2002.<sup>1</sup> Had this case been an Employer Abatement Scheme case, the delays in taking action would have allowed an erroneous refund to be issued.

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<sup>1</sup> The taxpayer's subsequent filing history indicated that the business paid substantial employment taxes after this, so the taxpayer was most likely not part of an Employer Abatement Scheme.

**Improved Screening of Potentially Fraudulent Employment Tax Refunds  
Would Reduce Significant Processing Delays for Legitimate Refunds**

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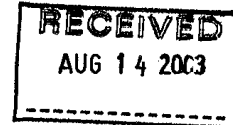
**Appendix V**

**Management's Response to the Draft Report**



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

AUG 14 2003



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: Dale F. Hart   
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improved Screening of Potentially  
Fraudulent Employment Tax Refunds Would Reduce  
Significant Processing Delays for Legitimate Refunds  
(Audit #200230027)

I have reviewed your report and agree with your findings and recommendations. To ensure that noncompliance is effectively addressed, we are improving our control of frivolous claims for refunds of previously paid employment taxes.

The Frivolous Return Program (FRP) identifies and processes frivolous tax return filings, including those that argue wages are not taxable because they do not meet the definition of gross income as defined by the law. The program recognizes the need to prevent inappropriate processing of frivolous claims and to educate taxpayers on their rights and responsibilities for properly filing and paying employment taxes.

Through the FRP, we are taking steps to reduce the number of frivolous claims for refunds. We established an FRP Issue Management Team (IMT) to address frivolous filing issues. We developed and improved criteria and procedures to identify and process frivolous employment cases. We also initiated civil and criminal actions against some promoters of the frivolously filed amended returns.

Our comments on your recommendations follow:

**RECOMMENDATION 1**

Develop procedures to control cases as they are received in the Frivolous Return Program and to monitor the age of these cases in inventory. Consideration should be given to using the Integrated Data Retrieval System (IDRS).



## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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### **CORRECTIVE ACTION**

Current FRP procedures require IDRS controls on all cases in inventory determined to be frivolous. Staffing in the FRP was increased to handle the growing number of leads. The FRP has designated a unit of tax examiners to work this issue. Additionally, management at the Ogden Campus monitor the FRP inventory for age as a standard operating procedure to ensure case movement and work continuity. The unit is meeting timeliness requirements.

### **IMPLEMENTATION DATE**

Completed.

### **RESPONSIBLE OFFICIAL**

N/A

### **CORRECTIVE ACTION MONITORING PLAN**

N/A

### **RECOMMENDATION 2**

Establish timeliness standard for working cases through each step of the screening process.

### **CORRECTIVE ACTION**

New Internal Revenue Manual (IRM) revisions will be written to require two-day turnaround on those Business Master File (BMF) returns Submission Processing identifies as potentially frivolous. The returns must be screened for frivolous positions and forwarded for processing within two business days of receipt if they are determined to be valid claims. This is the only "step" in the screening process and we are successfully meeting the timeliness standard.

### **IMPLEMENTATION DATE**

February 15, 2004

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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### **CORRECTIVE ACTION MONITORING PLAN**

The Service Center Compliance Program Manager will advise the Director, Reporting Compliance, of any delays in publishing the new IRM procedures.

### **RECOMMENDATION 3**

Analyze potential Employer Abatement Scheme workloads and determine an appropriate staffing level to allow cases to be worked timely.

### **CORRECTIVE ACTION**

Staffing in FRP was increased to better address the growth in the filing of frivolous claims for refunds. We have not found a way to effectively project future receipts but have been successful in balancing resources to address unanticipated spikes in receipts. This is evidenced in our accomplishment in meeting timeliness requirements.

### **IMPLEMENTATION DATE**

Completed.

### **RESPONSIBLE OFFICIALS**

N/A

### **CORRECTIVE ACTION MONITORING PLAN**

N/A

### **RECOMMENDATION 4**

Provide criteria for referring cases to the Frivolous Return Program that are much more specific. Consider including a dollar tolerance in these criteria.

### **CORRECTIVE ACTION**

In May 2003, we modified screening criteria based on dollar amounts. Additionally, the IMT is presently developing supplementary criteria and will share it with the FRP once it's completed.

## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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### **IMPLEMENTATION DATE**

November 15, 2003

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Service Center Compliance Program Manager and Abusive Tax Avoidance Transaction (Domestic) Program Manager will advise the Director, Reporting Compliance, of any delays in implementation of the IMT recommendations.

### **RECOMMENDATION 5**

Develop specific research procedures and criteria to identify truly "frivolous" employment tax claims and to ensure that legitimate claims receive prompt processing, and then update those procedures as experience in this area warrants.

### **CORRECTIVE ACTION**

Procedural guidelines have been revised to improve the accuracy of our identification of frivolous claims. Our new systemic filters will also help to improve the identification process. As new "schemes" are identified, both procedural and systemic criteria will be updated accordingly.

The IMT will also make recommendations to FRP on new variations on filings as they are identified. This information will be used to determine the appropriate account research steps to be taken by tax examiners and will be included in training materials. The FRP provides annual training to both Submission Processing and Accounts Management on how to identify frivolous filings. Training material updates include BMF frivolous filings. Training efforts will continue at the Cincinnati and Ogden campuses where BMF returns are processed. This will ensure prompt processing of legitimate claims. We are already meeting the timeliness standards that we set.

### **IMPLEMENTATION DATE**

March 15, 2004

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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### **CORRECTIVE ACTION MONITORING PLAN**

The Service Center Compliance Program Manager and Abusive Tax Avoidance Transaction (Domestic) Program Manager will advise the Director, Reporting Compliance of corrective action delays.

### **RECOMMENDATION 6**

Develop performance measures to evaluate the success of this program. Methods should be developed for using feedback from field Compliance functions on cases referred for action. Similar feedback should be provided to processing groups referring potentially frivolous claims to the Frivolous Return Program.

### **CORRECTIVE ACTION**

The FRP currently provides feedback to referring offices when potentially frivolous returns are received and determined not to be frivolous. The IMT will develop field compliance performance measures, as well as using feedback on cases referred to the program.

### **IMPLEMENTATION DATE**

March 15, 2004

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Abusive Tax Avoidance Transaction (Domestic) Program Manager will advise the Director, Reporting Compliance of corrective action delays.

### **RECOMMENDATION 7**

The Director, Compliance, SB/SE Division, and the Director, Customer Account Services, Wage and Investment Division (W & I), should work together to develop revisions to Computer Paragraph (CP) 080 and/or to Frivolous Return Program screening procedures to ensure that taxpayers responding to one IRS notice do not receive another regarding the same issue which also implies that the taxpayer may be participating in a scheme.

## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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### **CORRECTIVE ACTION**

Timely turnaround of potentially frivolous employment tax filings will reduce the possibility of duplicate notices being sent. The CP 080 notice is a computer paragraph issued to taxpayers that have made employment tax payments but have not filed tax returns related to those payments. This notice is owned by W & I, but is sent to only business taxpayers. The SB/SE Division will request ownership of the notice. Reporting Compliance will then evaluate the notice for necessary content changes.

As previously stated, we modified screening criteria in May 2003 based on dollar amounts. The IMT will share specific screening criteria with the FRP.

### **IMPLEMENTATION DATE**

March 15, 2004

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Service Center Compliance Program Manager will request ownership and advise the Director, Reporting Compliance of any corrective action delays.

### **RECOMMENDATION 8**

The Director, Compliance, SB/SE Division, should consider using computer programming to identify both original and amended employment tax returns that may be part of Employer Abatement Schemes.

### **CORRECTIVE ACTION**

A Request for Information Services (RIS) was submitted to develop a filtering mechanism to cull frivolous claims. The RIS will also allow for the filtering criteria to be modified/revised as needed. The RIS will be implemented in January 2004.

Additionally, Compliance Policy is pursuing an external contract to develop a "data-mining" application. This data-mining application will look at frivolous claims and establish common elements. Once the elements are established, the data-mining application will refine and/or supplement the elements to improve the identification

## **Improved Screening of Potentially Fraudulent Employment Tax Refunds Would Reduce Significant Processing Delays for Legitimate Refunds**

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process which will develop data-mining algorithms to identify abusive filings and frivolous return schemes.

### **IMPLEMENTATION DATE**

March 15, 2004

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Small Business/Self-Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Service Center Compliance Program Manager will advise the Director, Reporting Compliance, of any delays in the RIS implementation.

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.